RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 • REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION
POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

MAY 1, 1985 LETTER 912

April 19 DJIA 1266.56; PTI 1730; A-D Ratio -16.34
April 26 DJIA 1275.18; PTI 1732; A-D Ratio -16.21

THE PICTURE: Here we are entering the second quarter of 1985, and as is so often the case on Wall Street -- confusion reigns. You want to be a bull? Then you can (hopefully) look forward to an exciting new "flat tax" bill this summer, and finally you can (hopefully) look forward to a landmark summit meeting between President Reagan and Mr. Gorbachev. Finally, you can (hopefully) look forward to a collapse in interest rates and a further explosion in the bond market.

You want the bearish side? Consider these items: Factory orders have been down in seven of the last 10 months, and business spending has been down in eight out of 10 months. Condo sales (and prices) are slipping, the farm situation is a disaster, the savings & loan picture may be just as bad and America's high-tech industries are reeling. Finally, the US trade balance continues to be a nightmare.

What, we ask, what does it all mean? And the truth is that there probably isn't a man or woman alive who knows. And that's precisely why I thank the gods of Wall Street for the stock averages.

In his great book "The Stock Market Barometer", William P. Hamilton wrote, "This is why the stock market barometer is so valuable. It makes little of cycles or systems, interesting or even well-grounded inferences or common fads. It uses them all so far as they are useful, together with every other scrap of information it is possible to collect. The market movements reflect all the real knowledge available, and every day's trading sifts the wheat from the chaff. ... Such as it is (the market) can honestly claim that it has a quality of forecast which no other business record yet devised has even approached." These words were penned in 1922. Nothing since then, as far as I am concerned, has changed.

In view of this, let's go over the market picture -- in terms of the Dow Theory. I stated in both Letters 910 and 911 that I wasn't particularly thrilled with current market action, but that we were very fortunate in one area. The D-J Averages were in a position where they would have to talk -- one way or the other.

In early March, the D-J Industrial Average recorded an all-time high of 1299.36 confirmed by a record high of 635.30 in the Transports. Then, in the face of almost universal predictions of "Dow 1300", the Averages declined. The decline low for Industrials was reached on March 15 at 1247.35 (see page 1 chart).

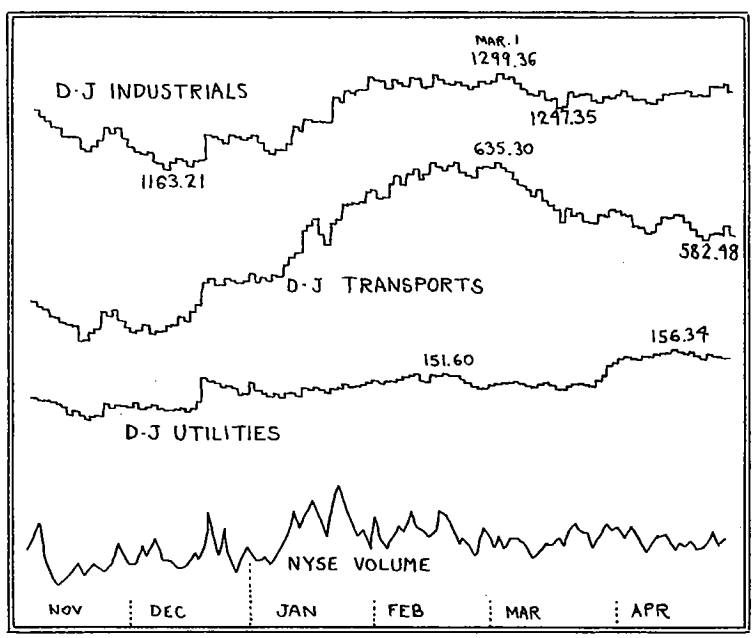
From the March 15 lows, the market attempted a rally. But the rally was sub-standard on most counts. The poorest aspect of the picture was the series of new lows in the Transports, lows recorded even as Industrials continued to advance.

By April 22, the Transports had retreated to 582.48, but happily Industrials were holding well above their critical 1247.35 level. April 23 saw Industrials jump over 12 points as the senior Average rallied to its best level since early March. By late last week the Transports were pushing up, finally moving in the same direction as Industrials.

What do we look for next? I would LIKE to see both Industrials and Transports advance strongly TOGETHER. I would like to see Transports put on a real show of strength. What would I NOT LIKE to see? I would not like to see Industrials turn weak and break below the 1247.35 level. Ultimately, the two Averages will get in gear. And the next MAJOR in-gear movement of the Averages will set the true direction of the market. Then we will know what Wall Street is thinking -- and doing.

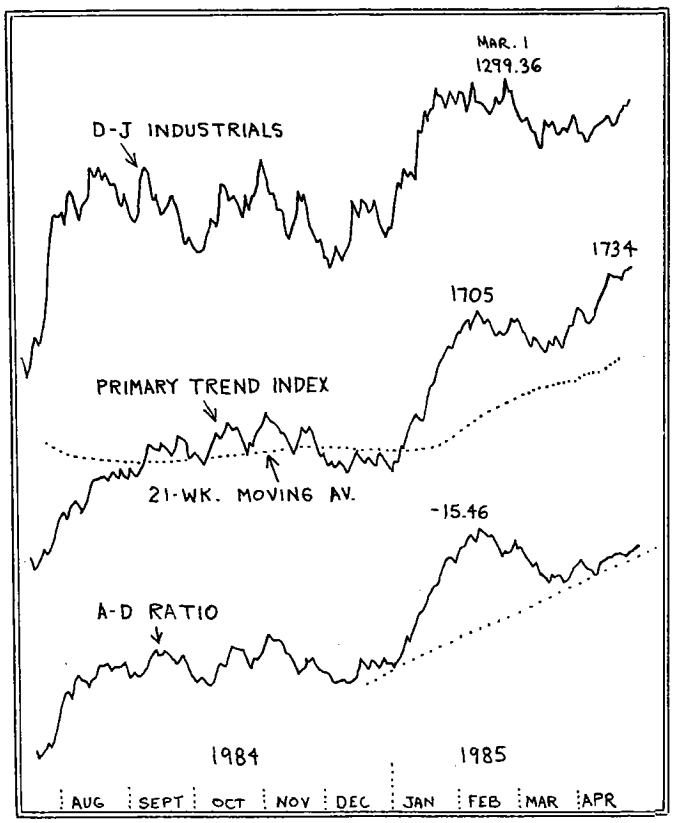
Now turn to the page 2 chart of the PTI. What we see here is a technical situation which is quite rare -- namely, a series of new highs in the PTI, new highs which have not been confirmed by either the Dow or the A-D ratio (at least so far). The persistent rally in the PTI has had the effect of dragging the Dow and the A-D higher. And this can continue as long as the PTI stays on its stubborn upward path.

I want to emphasize this: a rising PTI always exerts a positive force on the market. A bullish PTI does



not guarantee a rallying market, but it is never accompanied by a falling market. Thus, as long as the PTI continues on its upward path we will either have sideways markets or rising markets. It is only when the PTI reverses to the downside that we can have trouble.

Asides: There are some positives in the technical picture that I should mention: (1) The trend of both margins and credit balances on the NYSE is up, and that's bullish. (2) Odd-lot shorts have been high recently, and that too is bullish. (3) Despite a sagging A-D ratio, the daily new lows on the NYSE have held to minor proportions, a third positive indication.



Add this as a fourth plus for the market: On April 26 both the NYSE Composite and the S&P 500 Index closed above their entire recent trading ranges -- to post new 1985 highs. It remains now for the Dow and the A-D to confirm.

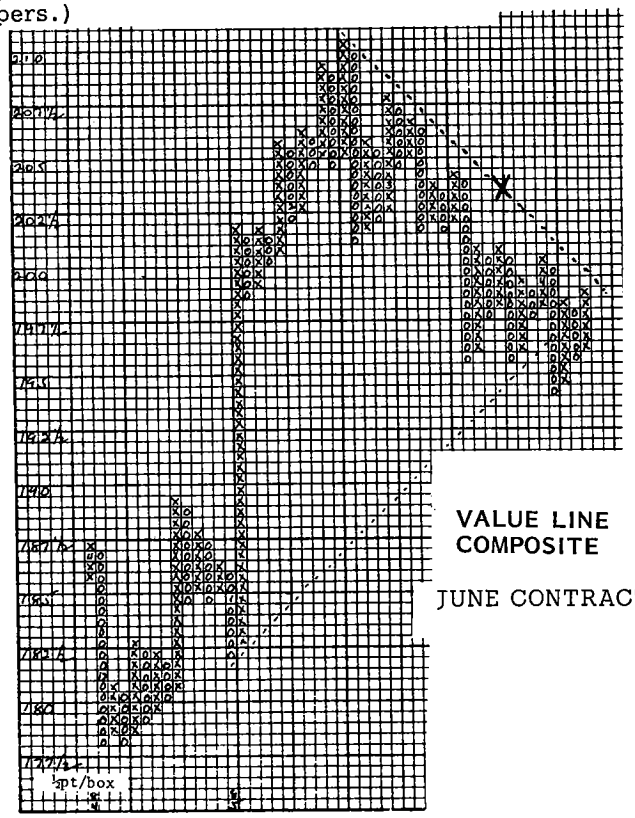
INVESTMENT POSITION: The more complex the market action, the greater my urge to keep it simple. The simple approach is this: the major trend of the stock market was last confirmed as bullish under Dow Theory. I would take the trend to remain bullish AS LONG AS the Dow can hold above 1247.35. I'm holding stocks, and I'll continue to hold them while the Dow respects that 1247.35 level. Break 1247.35, and I'll be easing towards the exits. There, that's simple enough. Note also that the PTI (page 2 chart) is holding well above its 21-week moving average.

I continue to like the action of the STRONGEST Dow stocks. They are Amer. Can, Amer. Tel., DuPont, Exxon, Gen. Foods, Owens Illinois, Westinghouse, Woolworth. I've said all along that the way to operate in today's market is to own the strongest Dow stocks. I haven't changed my mind--except to add utilities to the list.

The latest bond market rally may well be topping out now. In the last Letter I said,"Let's see if the June T-bond contract can confirm the June T-bill contract by rising to a new high." The T-bonds failed the test, and last week they declined fairly sharply. With lower bonds come higher interest rates, and with higher interest rates the dollar becomes more attractive. So the foreign currencies took a dive in the face of rising Treasury yields. These are volatile markets, and currency trading is basically for professionals (or masochists).

The federal deficit for the first six months was $128.1 billion, up 8.8% over last year's $117.7 billion. With business now slowing down, tax receipts could be dropping off. This could give us a 1985 deficit that is a sight to behold. Those are the fundamentals and I don't care how much manipulation comes out of the Fed. Watch the bonds as we move into "budget debate time."

VALUE: One of the laggards in this stock market has been the broad Value Line Composite. This chart (courtesy of Chartcraft) provides an interesting way to monitor the current market. Watch the June Value Line contract. If the June Value Line can touch 201.00 then the Value Line will have reversed the major bearish trendline (X on chart) and at the same time the June Value Line will have given a bull signal. When the weakest average finally turns bullish--that's a very positive note. So watch that June Value Line contract for 201. (The Value Line appears in the commodity section of most daily papers.)



VALUE LINE COMPOSITE

JUNE CONTRACT

YIELDS AND FUNDAMENTALS: In the Wall Street Journal, July 11, 1901, Charles Dow wrote a paragraph which will live in the annals of investment philosophy:

> "If people with either large or small capital would look upon trading in stocks as an attempt to obtain 12% per annum on their money instead of 50% per week, they would come out a good deal better in the long run. Everybody knows this in its application to his private business, but the man who is prudent and careful in carrying on a store, a factory or a real estate business, seems to think that a totally different method should be employed in dealing with stocks. Nothing is further from the truth."

In my own investment philosophy, I have always thought of my investments as a second business (my first, of course, being to publish an advisory report). My concept of a second business is a business that provides a second income. As such, this second business enhances my standard of living and in due time my second business may even surpass my basic income from my primary business.

In other words, I don't look on my investments as a game, a source of excitement or a financial crap shoot. I want to keep my investments on a strictly business level, and I am interested above all in a basis for a second income. I am afraid that many (actually most) people lose sight of this simple fact. Unless you are a professional trader or a member of an exchange, your investments are simply an auxiliary business, and they should be treated as such.

If the average subscriber would view his stocks and bonds in this way, I can't tell you how much agony, how many needless losses would be avoided. Furthermore, a mass of bad investment and trading advice would be ignored.

The investor would have a plan, stick to that plan, and find little need for tips, advice and encouragements from outside sources.

As subscribers know, I have been talking about the outstanding value of bonds ever since last summer (at which point the bond market bottomed out). It is interesting to note that fund purchases of common stocks are now down fairly sharply while at the same time the funds are buying roughly four times as many bonds (in dollars) as stocks. Evidently, the funds have taken in what Dow wrote over 80 years ago.

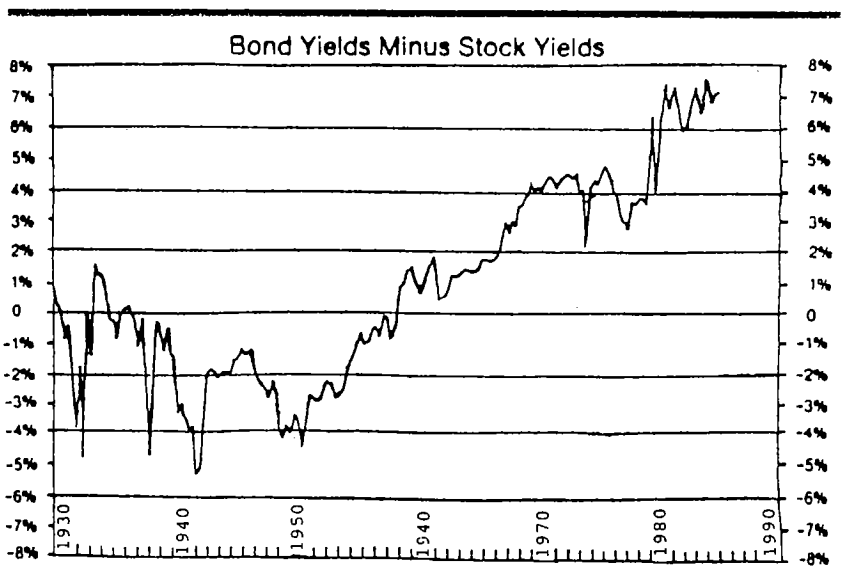
Consider this. At last summer's prices (and in fact until very recently), we could buy long-term Treasury bonds at yields of around 12%. That 12% is the same goal that Dow suggested that investors try for. In other words, Treasury bonds with a very safe 12% were providing exactly what Dow indicated, 12% per annum. On that basis, did it pay to load up on stocks with average yields of 3% to 6% (with the exception of utilities which were yielding 7% to 11%)? I'll leave the answer to you.

This very long term chart (courtesy Smith Barney) offers a perspective on the subject. Here we see the yield differential between bonds and stocks, which is currently in favor of bonds. This differential is now about 7% and around its highest level in history.

The negative spread in favor of bonds is the biggest investment problem facing stocks today. It appears to be telling us that on a return basis, bonds must rally (thus reducing bond yields) before stocks can rise appreciably higher. The other problem, of course, is the trend of corporate profits. A tremendous surge in corporate profits and dividends would also send stocks higher simply by reducing the bond/stock yield spread.

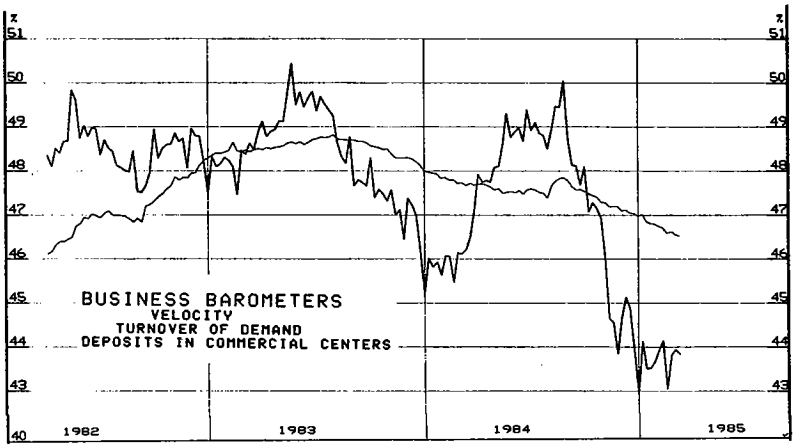
I might add that the bond/stock yield problem is one of the reasons why Wall Street is so focussed on bonds today. Consciously or unconsciously, sophisticated investors know that Treasury bonds with yields above 11% or tax-free munis with yields around 9% offer murderous competition for stocks. After all, current bond returns are very near the ideal that Charles Dow described in 1901. And the fundamentals Dow wrote about then--have NOT changed.

Incidentally, all of the foregoing also explains why investors are now so obsessed with the federal budget and the deficits. Unless the deficit problem is solved, we are fated over the next year or so to see new highs in yields in the bonds market. Such highs would be all the more significant in the current world of low inflation rates. Today's high yields and low inflation rates are providing investors with the highest REAL interest rate returns in history.



BIG PAULIE: Your name is Paul A. Volcker. The hard money wiseguys used to call you Adolf Volcker (yeah, after Hitler), but the hard money boys are kind of quiet now, with inflation bumping along at 4-5%. One moron wrote that you and the Fed were destroying the dollar. "Yeah," you snapped, "and where do you think the dollar would be if I quit the Fed tomorrow?" The guy didn't answer.

Now you're looking at a chart (page 4) of the US trade balance and another of manufacturing imports. And they look terrible. You've been tackling tough problems ever since you took this darn job, but today's problems are the toughest yet.

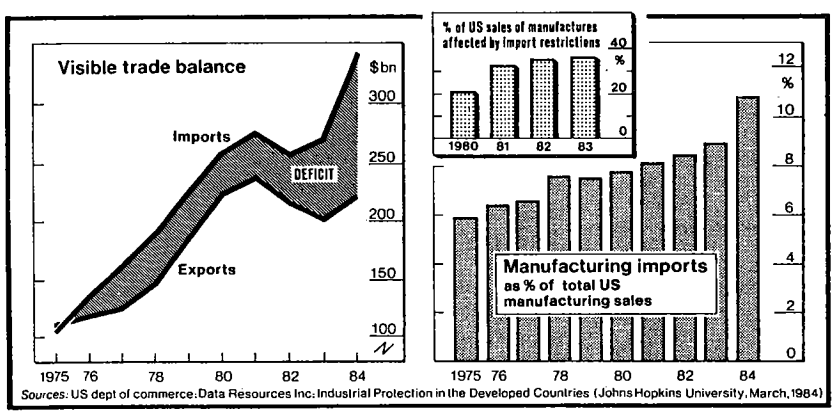


You wonder if it's all worth it. Sure, you've got the clout. Don't the newspapers refer to you as "the second most powerful man in the country"? You better believe it. Does Reagan want you out? Maybe, maybe not, but if he does he's sure keeping it a secret. There isn't a politician in America who has the guts to tell you to take a hike. That's power, buddy.

But power doesn't eliminate worries. You've been looking at the picture of sagging money velocity (see chart, courtesy of Mansfield) and you don't like it. Sagging velocity means you've got to pump more money into the economy, and you're reluctant to do it. The Fed watchers and inflationists jump all over you. But you wonder, why the devil is velocity slowing down? You don't like your own answer, but you might as well face it. Corporate earnings are sinking, and business looks like it could head south for the summer and fall.

What to do now? The toppy looking dollar worries you too. Frankly, the dollar worries you when it's strong--and it worries you when it's weak. But suppose the dollar has topped out, and suppose it's heading down? Sure, that'll help US exports, but what about the deficit? A sliding dollar is going to make it hell to sell debt to foreigners, and if the dollar goes down too far you're going to have to raise interest rates. Then everybody is going to scream that Volcker is a Trilateral traitor.

Let 'em moan. Did Congress help you out? What did Congress do? Those lily-livered politicians argued and danced and jawed, but they didn't really make the real cuts. You kept warning them. You said they had to make the big cuts. You said the $50 billion was just a start. So what happened? Damn little, that's what happened.


Visible trade balance
$bn
Imports
DEFICIT
Exports
1975 76 78 80 82 84
% of US sales of manufactures affected by import restrictions
1980 81 82 83
Manufacturing imports as % of total US manufacturing sales
1975 76 78 80 82 84
Sources: US dept of commerce; Data Resources Inc; Industrial Protection in the Developed Countries (Johns Hopkins University, March, 1984)

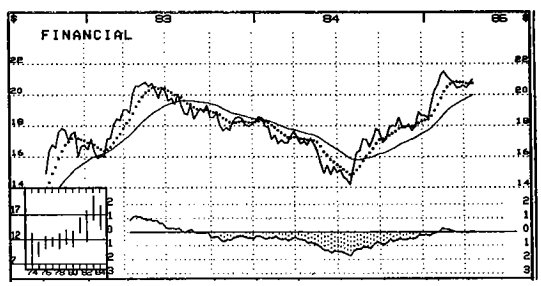
And OK, suppose the dollar stays strong? Then what? How long can the American economy take the tidal sweep of imports, imports that are knocking industry into a cocked hat?

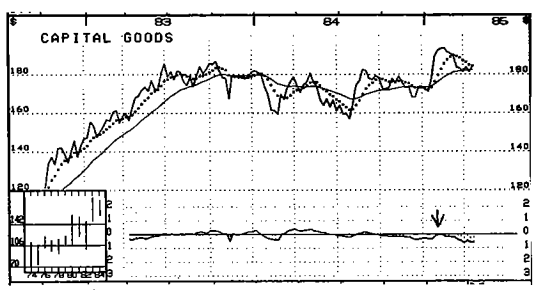
Maybe the economy will stay strong but not too strong. Maybe the dollar will slide off a bit but not too far. Maybe interest rates will come down some--but not a lot. Maybe you've been smoking too many cigars. I mean, don't the cartoonists have a field day with your six-foot seven height and the ever-present twelve inch cigar? How much longer, oh Lord, how much longer? But don't you ever forget it, you're the second most powerful man in the US, and you don't buy that title with greenbacks, you buy it with prestige, integrity and aw hell, there goes the telephone again. Those idiots in the Senate want me to appear again. Gimme a break, will ya!

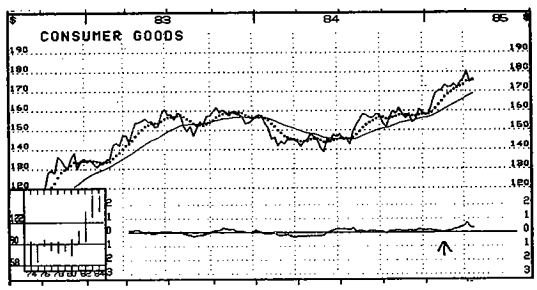
INFO: All the financial and business information you need to know, and more, is built into the action of stocks. It only remains for us to interpret that information.

These three charts tell us quite a bit. They are group charts from Mansfield, each showing price action of the group, position of the group in relation to its own moving average, and relative strength of the group compared with the rest of the market.

Here's what I see. The Financial group, after acting poorly during all of 1983, turned up in mid-1984 and of late this group has been acting very slightly better than the market (note relative strength). That's a good sign, although I'd like to see that relative strength line move up from here.







The capital goods group has been hanging on, and over the last quarter the group has been acting worse than the market. That is not a good sign for the economy. You don't get sustained bull markets on just consumer buying.

In their latest report (Industry Forecast), the Levys of Chappaqua, NY state, "...some aspects of capital investment are excessive as measured by the needs of the economy. Nearly one-fifth of the nation's industrial capacity is idle." The Levys also point to "involuntary accumulation of inventories, excessive commercial and residential construction and buildup of idle industrial capacity." To put it bluntly, the Levys see the US moving into a deep recession. If the Dow breaks 1247.35, I'd say that Wall Street agrees.

At the bottom we see the consumer goods group. This has been the star of the stock market, and you can see that the relative strength of this group is the best of the three. But consumers are now loaded with debt, and economists wonder how much longer they can keep up their buying binge. With capital goods moving sideways, I would say that a downturn in the consumer goods stocks at this point would be forecasting recession. So this group, in my opinion, is the one to watch.

NOTES & QUOTES:

SHOCKER: This little item deserves a paragraph all on its own. Last week I talked to Melvyn Lippman of US Organization Chart Service here in La Jolla. Lippman has been my military expert, as older readers know and he filled us in on "Star Wars" about a year before it became public knowledge. He told me that he has calculated the US military budget for the five years from 1986 to 1991. The figure he gave me is "the minimum." Here it is: for the next five years the military budget will be $2.275 trillion. "And that's the absolute minimum," Lippman added. It's worth pondering, isn't it.

* *

Leveraging America: No less a person than Nicholas Brady, Chairman of Dillon, Reed & Co., wrote the following regarding the 1984-85 torrent of so-called "junk bonds" (from a recent WSJ letter to the editor):

Many Wall Street colleagues — indeed, my own firm — earn significant profits from sponsoring and defending against hostile junk-bond takeovers, so perhaps our interest is served by looking the other way. But we should not — because these activities represent an abuse of the system that is among the most serious I've seen in 30 years. Speculative, highly leveraged financing techniques involving junk takeover bonds, if unchecked, will leave misery in their wake.

Junk bonds — essentially high-risk, high-yield, less than investment-grade debt — have long been around. What is new, and dangerous, is the rapidly expanding use of such securities to finance highly leveraged hostile acquisitions. Junk takeover bonds most often take the form of unregistered, unrated or low-rated debt or quasi-debt securities. Usually, they are issued by a shell corporation created as the vehicle for a hostile takeover attempt. These bonds entail substantial risks to investors — risks that often have not been, and cannot be, adequately assessed.

An avalanche of hostile takeover financings using junk bonds is rolling through the markets. For example:

- $5.4 billion in junk takeover securities for Turner Broadcasting to take over CBS.
- $3 billion in junk takeover securities for Mesa Partners II to take over the Unocal Corporation.
- $400 million in junk takeover securities for Sir James Goldsmith to take over Crown Zellerbach.

What's worrisome is that junk takeover financing — which is largely devoted to unproductive purposes — dangerously threatens to destabilize America's national savings system. As we have seen in the collapse of ESM Government Securities Inc., when major investors reach for higher yields without regard for security and safety of principal, the results can be disastrous.

The history of oil has always fascinated me. Do you know what happened during the Great Depression? Here's a capsule description from EJAG magazine:

The oil famine that had been predicted for the twenties never occurred. Instead an oil boom followed that nearly capsized the petroleum industry. Discovered by wildcatter "Dad" Columbus Marion Joiner at a site where no geologist of the day had expected to find oil, a giant five billion barrel field near Longview, Texas, drove the price from $1.10 to 10 cents a barrel. In contrast to the Texas oil's bargain price, chili served at a Longview eatery sold for 15 cents a bowl.

With the nation, and the world, entering economic depression the new oil deluge simply could not be absorbed. To salvage the petroleum industry, the states of Texas and Oklahoma shut down their oil fields by martial law. This action, a foreshadowing of the Arab Oil Embargo of 1973, and subsequent formation of OPEC, stood in force until the oil companies and operators worked out a production quota that could restore oil prices.

* *

Dept. of Unusual Financial Facts: The underground US economy is the seventh largest economy in the world.....The current US tax code is longer than the King James version of the Bible.....There are currently more tax preparers than there are members of the US Naval Reserve and the Army National Guard combined.

In 1945 union members constituted 35% of the entire US work force. By 1980 the figure had dropped to 23%. Current figure: 18.8%. Reasons: shift of work force from manufacturing to service, shift of work force from Northern states to union hating Southern states, shift in labor and the public's attitude towards unions.

Political Notes: Jeane Kirkpatrick may well want the 1988 Vice Presidential nomination. She has already switched parties (maybe Bush and Kirkpatrick?). Mrs. K. also had $1 million in lecture fees lined up to 1985. Here is 1988 as New York Times columnist William Safire sees it:

> Who will emerge as the nominees for President? If you go by the likely results of early polls, the choices will be Ted Kennedy versus George Bush (with Bush the favorite); if you listen to the Washington insiders, it will be Mario Cuomo versus Jack Kemp (with Cuomo the favorite); if you believe in miracles, and like to bet on dark horses, it will be Lee Iacocca versus Jeane Kirkpatrick (with everyone too stupified to express a choice).

* *

Forget about the $700 screwdrivers and the $1000 toilet seats. Those are peanut idiocies. One of the real problems with the US military is one that even Reagan won't talk about. What's the problem? It's the stupefying mass of personnel that literally chokes up the services. It's been estimated that well over 100,000 people could be fired from the Pentagon--and the result would be increased efficiency. Also, the ratio of officers to enlisted men in the services is insanely lopsided in favor of officers.

You're skeptical? Mull over this piece from the April 3 speech by John Lehman, Secretary of the Navy:

I see principal problems to be dealt with in the coming years.

First and foremost is bureaucracy. It would be impossible for me or anyone at this table to accurately describe to you the system with which, and within which, we must operate. There are thousands upon thousands upon thousands of officers and entities and bureaus that have been created over the years to deal episodically with aspects of defense. The Office of the Secretary of Defense, originally 50 people, is now 2,000 people. The Joint Staff, originally to be not more than 100 people, is now 2,000 people. The Office of the Secretary of the Navy, the Chief of Naval Operations and the Commandant of the Marine Corps, originally to be 300 people, is now 2,000 people. The Defense Logistics Agency, originally to be the "coordinator" of commodities, is now 50,000 people. There are 11 defense agencies, 9 joint and specified commands with staffs that run into the thousands each.

These are the results, every one of them, of reform. Each was created in the name of "inter-service unity" "jointness" and "reform progress." What has been created over the past 40 years is an incredible, and unwieldly, "monster."

It is just as bad on the operational side, in the proliferation of commands and headquarters, as it is in the material side in the procurement and management of our resources. It is not the fault of any single regime, of any single person, of any single period. It is the accumulation of the facile, glib, solutions of armchair experts who know not, or whereof, they speak; yet who, like dripping water, have accumulated stalactite of democracy year after year after year.

* *

Nathan Pritikin was the man who developed the famed Pritikin exercise and diet regime. Pritikin died recently (of cancer). Pritikin suffered from angina as far back as 1957, and it was then that he began work on his no fat, low salt, no red meat, high vegetable and high complex-carbohydrates diet. An autopsy showed that Pritikin (and remember, he suffered from angina) possessed arteries that were clean of cholesterol. Physicians have claimed that cholesterol buildup in the veins and arteries is irreversible. But Pritikin's clean arteries certainly makes me wonder. And I guess a lot of other people are wondering too.

The fact is that there are now 34 million vegetarians in the US. And the ranks of the veggies are growing. Personally, I am convinced that whole wheat, vegetables, fruits, low or no fat, very low salt is the way to go. The sufferers are going to be the meat producers of the US. Maybe this is why the commodity meat complex has just dropped to a new low for the year. At any rate, I do think that the trend to vegetarianism is going to affect meat producers severely. When McDonalds goes into a bear market, you'll know it's happened!

GOLD: A plus for precious metals is the fact that the gold/common stock ratio has now turned up in favor of gold. This in no way guarantees that gold will move higher, but all major bull moves in gold have occurred only when the ratio is in the current bull mode.

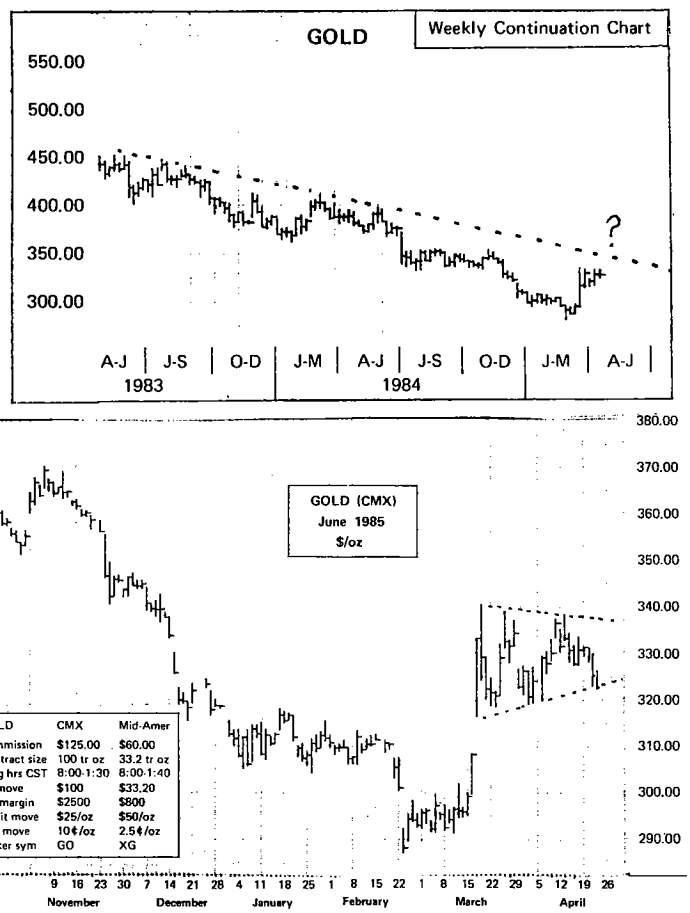
Last week metal bellwethers platinum and palladium faded. Silver put on a fairly weak performance. This despite the fact that inflation picked up to a 5.8% annual rate, and the head of the New York Fed stated that faster money creation may be needed to prevent a recession.

I feel neutral on gold and the metals. I'll give gold the benefit of the doubt by saying that February's spot 284.25 price could be the bottom of the gold bear market. I'm not convinced, but then I don't convince easily. Gold ran from 284 to almost 340 so the halfway mark for that climb is roughly 312. As long as gold holds above spot 313 I'd say that goldphiles are entitled to be optimistic. Gold below 312, and certainly below 300, and you can have my coins. Yes, I have a few handfuls of Maple Leafs, but I haven't taken a significant position myself on gold.

There is a fundamental situation here which could change the precious metals outlook. If inflation really heats up, say the CPI goes to 10% or 12%, then the current mountain of debt (bonds, loans, mortgages, etc.) is going to start sagging. That mountain of debt is now a lot bigger than it was in 1979 or 1980. And today's money markets are far more sensitive to inflation. Thus, rising inflation would produce sagging debt markets and whopping highs in interest rates. The result would be recession and deflation. Thus, in my opinion, debt is now the big tail that wags the little dog. Inflation today contains the seeds of its own rapid self-destruction.

If this analysis is correct, then there is only one thing that really would drive the metals into the stratosphere again. The one thing is a collapse in the US banking system or mass reneging on international debt or both. Barring chaos in the banking system, I don't see a MAJOR move in the metals. But, of course, I've been wrong before.

I've updated the accompanying Dunn & Hargitt daily chart. Here we see the June gold contract with its latest formation, a triangle bordered by 340 on the upside and 320 on the downside. A decisive breakout from this triangle should point the next intermediate move for gold. I might add that the Comex exchange (futures) really sets the price for gold now. London simply adjusts to the CMX closing, but the price-setting for gold has switched from London to the US.



NEXT MAILING: May 15